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In the Supreme Court of the United States

OCTOBER TERM, 1969.

No. _____.

LANRAO, INC.,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Appeals
For the Sixth Circuit.

Petitioner respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered in the above-entitled case.

OPINIONS BELOW.

The per curiam opinion of the Court of Appeals for the Sixth Circuit (Appendix B, p. 27) is not yet reported. The initial opinion of the United States District Court for the Eastern District of Tennessee, Southern Division (Appendix B, p. 12) is reported in 288 F. Supp. 464. Neither the District Court's first or second revision (Appendix B, pp. 23, 25) of its opinion is reported.

JURISDICTION.

The judgment of the Court of Appeals was entered February 5, 1970 (Appendix B, p. 28). The jurisdiction of the District Court was based on Title 28 U.S.C.A. Sec. 1340. The jurisdiction of this Court is invoked under Title 28 U.S.C.A. Sec. 1254(1).

QUESTION PRESENTED.

The sole question presented is whether or not expenses incurred by petitioner in 1963 in the sale of all of its assets, incident to its complete liquidation under Section 337 of the Internal Revenue Code of 1954 ("1954 IRC"), are ordinary and necessary business expenses, deductible under Section 162(a) of the 1954 IRC in determining its taxable income.

STATUTORY PROVISIONS INVOLVED.

Statutory provisions involved here are set forth in Appendix A, p. 10.

STATEMENT OF CASE.

This action seeks recovery of income taxes paid for the calendar year 1963.

Pursuant to a plan adopted by its stockholders on December 2, 1963, petitioner was completely liquidated within twelve months after that date.

Incident to such liquidation, it sold its entire assets for $12,225,688, which exceeded the adjusted basis of such assets, for income tax purposes, by $5,941,394.65. Of such excess, $267,294.46, resulting from post-1961 deductions for depreciation on its tangible personal property, was, under Section 1245 of the 1954 IRC, ordinary income to petitioner upon which it paid corporate income taxes. The remaining excess, $5,674,045.54, was not, under Section 337 of the 1954 IRC, a recognized gain.

In its tax return for 1963 petitioner claimed deduction as ordinary and necessary business expenses of $156,961.79, which it had incurred directly in connection with such sale of its assets. This deduction was by the Internal Revenue Service "disallowed as a deductible ex-

pense and treated as an expenditure to be subtracted from the capital gain realized on the sale of the capital assets." This suit was filed following payment of the deficiency resulting from such audit action, filing of a claim for refund therefor, and nonaction on the claim for six months.

Initial Opinion of District Court.

The Court of Appeals affirmed the decision of the District Court in a per curiam decision without an opinion, simply stating its agreement with the conclusion reached by the District Court.

The District Court did not make findings of fact and conclusions of law. The gist of the Court's findings and opinion was as follows:

> "* * * The single issue presented is whether, in a corporate liquidation made pursuant to the provisions of § 337 of the Internal Revenue Code of 1954 * * * expenses incurred in the sale of corporate assets may be deducted in the year in which they were incurred as ordinary and necessary business expenses, as contended by the taxpayer, *or whether such expenses must be offset against the capital gain realized in the sale, as contended by the Government.*
>
> "* * * *As reflected in the plaintiff's 1963 income tax return, the plaintiff made a gain of $5,941,340 on the sale of its assets.*" (Emphasis supplied.)

After commenting:

> (i) upon the decisions of the United States Court of Appeals in *Pridemark, Inc. v. Commissioner,* 345 F.2d 35 (C.A. 4) and *United States v. Mountain States Mixed Feed Co.,* 365 F.2d 244 (C.A. 10), which held that expenses incident to a sale in a Section 337 liquidation are deductible as ordinary and necessary business expenses; and

(ii) upon the decisions of the United States Court of Appeals in *Alphaco, Inc. v. Nelson*, 385 F.2d 244 (C.A. 7) and *United States v. Morton*, 387 F.2d 441 (C.A. 8), which held that such expenses are not deductible by the corporation as ordinary and necessary business expenses,

the District Court followed the rulings by the Seventh and Eighth Circuit Courts of Appeals, saying:

> "This Court accordingly concludes that legal fees and other expenses incurred in the sale of corporate assets in a corporate liquidation made pursuant to the provisions of § 337, Title 26 U.S.C.A., *must be offset against the capital gain realized in the sale and may not be deducted as ordinary and necessary business expenses.*" (Emphasis supplied.)

On the basis of such ruling the Court dismissed the case.

District Court's Memorandum Opinion Setting Aside Order of Dismissal and Revising Opinion.

Petitioner moved that the order of dismissal be withdrawn and judgment be entered in favor of petitioner for the full recovery sought, in accordance with the District Court's said opinion, namely: that expenses of sale should be offset against the gain realized on the sale, the only gain realized being the amount of $267,294.46 under Section 1245, which exceeded the expenses of $156,961.79.

The District Court, responsive to such motion, set aside its dismissal order and amended its opinion, in substance as follows:

> "* * * It is apparent that the *sales expenses incurred were incurred in a sale which resulted in both a capital gain* and a gain taxable as ordinary income. It is also apparent that *the portion of the selling ex-*

> ***penses attributable to the production of capital gain should be offset against the capital gain thus produced*** and the portion of the selling expenses attributable to the production of gain taxable as ordinary income should be offset against the gain taxable as ordinary income thus produced. *The total expenses would be subject to apportionment in the proportion that the capital gain* and the gain taxable as ordinary income each respectively bear to the total gain." (Emphasis supplied.)

The District Court directed entry of a judgment in favor of petitioner, computed in accordance with such revised opinion.

Final Revision of District Court's Opinion.

The District Court's second memorandum opinion merely corrected the Court's error, in its first revised opinion, with respect to the computation of the excess of the sales price above the adjusted basis of the property sold.

REASONS FOR GRANTING THE WRIT.

I. The decision of the Court of Appeals herein is in conflict with decisions of the Courts of Appeals for the Fourth and Tenth Circuits, *supra*, p. 3. It follows decisions of the Courts of Appeals for the Seventh and Eighth Circuits, *supra*, p. 4.

II. The question of deductibility by a corporation for income tax purposes of sales expenses incurred in a complete liquidation under Section 337 of the 1954 IRC is a highly important and recurring question of Federal income tax law which has not been, but should be, settled by the Supreme Court of the United States.

III. The decision of the Court of Appeals that the expenses of sale of petitioner's assets in its liquidation under Section 337 of the 1954 IRC "must be offset against the capital gain realized in the sale" is contrary to the plain language and announced purpose of Section 337.

The section provides that if (i) a corporation adopts a plan of complete liquidation, and (ii) within the twelve months period following all of its assets, less amounts retained to meet liabilities or claims, are distributed in complete liquidation of the corporation, no "gain or loss shall be recognized to such corporation from sale of its properties within such twelve months period."

In its ruling that petitioner realized capital gain of $5,674,045.54 on such sale of its assets, the Court of Appeals accepted the erroneous theory of the Courts of Appeals of the Seventh and Eighth Circuits in *Alphaco, Inc. v. Nelson,* and *U.S. v. Morton, supra,* p. 4, as urged by the Government below.

Both treated the excess above basis of amounts received for assets in a Section 337 liquidation as "capital gain."

Thus, *U.S. v. Morton* held that expenses of a corporation incident to the collection of nontaxable fire insurance proceeds in a Section 337 liquidation "should be treated as capital expenses that serve to reduce the capital gain" realized as a result of such involuntary conversion.

Alphaco, Inc. v. Nelson, reciting that the corporation involved in a Section 337 liquidation sold its assets "at a gain in excess of one million dollars," held that the expenses involved in such sale "are to be treated as offsets against the selling price relevant only to the determination of capital gain or loss."

Moreover, *Alphaco, Inc. v. Nelson, supra,* holds that in a qualifying liquidation under Section 337 the purpose

of such section to equate the tax payable so that it will be the same whether:

(i) sale of assets is made by a corporation which then distributes the proceeds to its stockholders; or

(ii) the corporation first distributes assets to its stockholders who then sell such assets,

is thwarted if expenses of sale by the corporation are allowed as ordinary and necessary business expenses.

Equating the tax is clearly not a purpose of Section 337.

> "By limiting the benefits to be derived from the elimination of a double tax to those who receive the gain within the twelve-month period, Congress assured the Treasury of its portion of the realized gain, which was to be obtained from the stockholders. *To be sure the tax upon the gain is different in theory and different in calculation when imposed at the corporate rather than the stockholder level. However, despite the discrepancy in tax theory and incidence, it is the single gain from the sale of specific property which is involved.*" (Emphasis supplied.) *C.I.R. v. McDonald*, 320 F.2d 109 (C.A. 5).

IV. The decision of the Court of Appeals is contrary to the IRS interpretation of Section 23(a) of the Revenue Act of 1928, which provided for deduction of ordinary and necessary business expenses in computing taxable income.

Such interpretation involved the case of *Pacific Coast Biscuit Co. v. C.I.R.*, 32 B.T.A. 39, decided in 1935, being the first reported case involving treatment of expenses incident to liquidation of a corporation.

Pacific Coast Biscuit Co. ("Pacific") in 1928 conveyed its assets to another corporation in exchange for common stock of the latter company which was issued to

the stockholders of *Pacific*. Such an exchange under Section 112(b)(4) of the Revenue Act of 1928 did not result in recognized gain or loss to *Pacific*. Expenses incident to such transaction and the corporation's liquidation and dissolution, deducted as ordinary and necessary business expenses under Section 23 of the Revenue Act of 1928, were disallowed by the IRS. The Board of Tax Appeals held that such expenses were deductible as ordinary and necessary business expenses.

The IRS twice published its nonacquiescence in this decision, first in 1935 in C.B. XIV-1, p. 35 and later in 1937-1 C.B. 45. However, in 1954-1 C.B. 6 published in the first half of 1954 after introduction in the House of Representatives of the 1954 IRC, but before its enactment, the IRS published its acquiescence in the *Pacific Coast Biscuit Co.* decision and withdrew its previous nonacquiescences.

The 1954 IRC was introduced in the House of Representatives on March 9, 1954, and was passed by Congress on July 29, 1954.

The adoption by Congress in the 1954 IRC of Section 162(a) (trade or business expense provision) without material change from Section 23(a) of the Revenue Act of 1928 (Section 23(a) 1939 Code) must be deemed legislative approval of such administrative construction by the IRS of the trade or business expense provision, as evidenced by such acquiescence in *Pacific Coast Biscuit Co. U. S. v. Dakota-Montana Oil Co.*, 288 U.S. 459 (53 S. Ct. 435); and *Brewster v. Gage, C.I.R.*, 28 U.S. 327 (8), of opinion (50 S. Ct. 115).

CONCLUSION.

For the reasons herein stated, it is respectfully submitted that this petition for a writ of certiorari should be granted.

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APPENDIX A.

STATUTORY PROVISIONS INVOLVED.

UNITED STATES CODE ANNOTATED TITLE 28.

Sec. 2106. Determination.

"The Supreme Court or any other court of appellate jurisdiction may affirm, modify, vacate, set aside or reverse any judgment, decree, or order of a court lawfully brought before it for review, and may remand the cause and direct the entry of such appropriate judgment, decree, or order, or require such further proceedings to be had as may be just under the circumstances."

Sec. 1254(1). Courts of Appeals; Certiorari.

"Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

"(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;"

Sec. 1340. Internal Revenue.

"The district courts shall have original jurisdiction of any civil action arising under any Act of Congress providing for internal revenue, or revenue from imports or tonnage except matters within the jurisdiction of the Customs Court."

UNITED STATES CODE ANNOTATED TITLE 26 INTERNAL REVENUE CODE.

Sec. 162(a). Trade or Business Expense.

"In General: There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *."

Sec. 337(a). Gain or loss on sales or exchanges in connection with certain liquidations.

"General rule.—If—

"(1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and

"(2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims,

then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period."

REVENUE ACT OF 1928 (INTERNAL REVENUE CODE OF 1939).

Sec. 23(a)(1)(A). Deductions from gross income.

"In computing net income there shall be allowed as deductions:

"Trade or Business Expenses.—

"In General.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *."

APPENDIX B.

OPINIONS AND JUDGMENT BELOW.

OPINION OF THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF TENNESSEE, SOUTHERN DIVISION.

(Filed August 21, 1968.)

This is an action to recover federal income tax in the sum of $81,620.13, plus interest, which the plaintiff taxpayer contends has been erroneously collected by the Government. All relevant facts in the case have been stipulated. The single issue presented is whether, in a corporate liquidation made pursuant to the provisions of § 337 of the *Internal Revenue Code of 1954* (26 U.S.C.A. § 337), expenses incurred in the sale of corporate assets may be deducted in the year in which they were incurred as ordinary and necessary business expenses, as contended by the taxpayer, or whether such expenses must be offset against the capital gain realized in the sale, as contended by the Government.

The material facts, as stipulated by the parties, are that upon November 27, 1963, the Seeburg Corporation offered to purchase all of the assets of the plaintiff corporation, which then went by the name of Cavalier Corporation. On December 3, 1963, Cavalier Corporation accepted the Seeburg offer, Cavalier Corporation's stockholders having authorized the acceptance at a meeting held upon December 2, 1963. At that same meeting a resolution was adopted by the stockholders of Cavalier Corporation changing the name of the corporation to Lanrao, Inc., and authorizing a complete liquidation of the corporation within a 12-month period, it being the stated purpose of the resolution that the liquidation should be conducted so as to qualify for non-recognition of gain under § 337 of the

1954 Code. The sale was consummated and the liquidation was accomplished in conformity with the provisions of § 337. In return for its assets, the plaintiff received $9,413,188 in cash and 120,000 shares of Seeburg common stock worth, in the aggregate $2,812,500. As reflected in the plaintiff's 1963 income tax return, the plaintiff made a gain of $5,941,340 on the sale of its assets. Of this sum, $267,294.46 was included, pursuant to § 1245 of the 1954 Code, as ordinary income, being that portion of the gain attributable to depreciation previously taken on the property sold. Pursuant to § 337, the balance of the gain was treated as gain non-recognizable to the corporation.

In listing its deductible expenses, the plaintiff claimed the right to deduct the sum of $171,070.82 in legal and other professional fees as being ordinary and necessary expenses deductible pursuant to § 162(a) of the 1954 Code. Upon the audit of the plaintiff's 1963 income tax return, the Internal Revenue Service allowed the deduction of $15,000 of this sum, it being agreed between the parties that this sum represented legal fees incurred subsequent to the sale of the corporate assets and in connection with the distribution of the proceeds of the sale and the liquidation and dissolution of the corporation. The remaining sum of $156,961.79, which is stipulated to "represent expenditures incurred by plaintiff directly in connection with the sale of its assets to Seeburg," was disallowed as a deductible expense. The disallowance of these expenses, which resulted in the taxpayer's having to pay a tax deficiency of $81,620.13, forms the basis of the present controversy. The parties having failed to effect an administrative settlement, this lawsuit was properly and timely filed.

Upon this state of the record it is the contention of the taxpayer that expenses incurred in the sale of its

assets were expenses incident to the complete liquidation and dissolution of the corporation, and that as such they were deductible as ordinary and necessary business expenses in the year of such complete liquidation or dissolution. In support of its contention that expenses incurred in the liquidation and dissolution of a corporation are deductible as ordinary and necessary expenses, the plaintiff relies upon a line of cases, including *Pacific Coast Biscuit Co. v. C.I.R.*, 32 B.T.A. 39 (1935); *United States v. Arcade Co.*, 203 F.2d 230 (C.A. 6, 1953); *Gravois Planing Mill Co. v. C.I.R.*, 229 F.2d 199 (C.A. 8, 1962); *Laster v. C.I.R.*, 43 B.T.A. 157, 177 (1940); *Rite-Way Products, Inc. v. C.I.R.*, 12 T.C. 475, 481 (1949); and *Mill Estate, Inc. v. C.I.R.*, 17 T.C. 910, 194 (1951). It is stated that the Internal Revenue Service in 1954 acquiesced in this line of authority, as reflected in 1 Cumulative Bulletin 6 of that year. The plaintiff further contends that since compliance with §337 of the 1954 Code rendered the gain on the sale of a liquidating corporation's assets non-recognizable as to the corporation, any expense incident to that sale should not be offset against the gain, but rather upon both reason and authority should be held deductible as an ordinary and necessary expense of the dissolution. As authority for this position the plaintiff cites a number of cases, including the cases of *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (C.A. 4, 1965) and *United States v. Mountain States Mixed Feed Co.*, 365 F.2d 244 (1966).

The Government, however, strongly contends that expenses incurred in the sale of capital assets are capital expenditures and that as such they must be deducted from the selling price of the assets in determining gain or loss. In support of its contention that expenses incurred in the sale of capital assets are to be treated as capital expenditures, the Government relies upon a line of cases and au-

thorities, including 4A Mertens, *Law of Federal Income Taxation* (Rev.) § 25.26 pp. 134-135; *Spreckles v. Commissioner*, 315 U.S. 626; *Helvering v. Winmill*, 305 U.S. 79; *Godfrey v. Commissioner*, 335 F.2d 82, 85-86 (C.A. 6th); *Davis v. Commissioner*, 151 F.2d 441, 443 (C.A. 8th); *Ward v. Commissioner*, 224 F.2d 547, 553-555 (C.A. 9th); *Estate of Machris v. Commissioner*, 34 T.C. 827, 829; *South Texas Properties Co. v. Commissioner*, 16 T.C. 1003, 1010; *Thompson v. Commissioner*, 9 B.T.A. 1342, 1345-1346. It is the position of the Government that the rule in this regard is universal and that the enactment of § 337 in 1954 did not and was never intended to change the rule.

Insofar as the parties' appeal to reason in support of their respective positions, the Court is of the opinion that the position of the Government is supported by the better and the stronger reasons. There appears to be no dispute but that the general rule is as stated in 4A Mertens, *Law of Federal Income Taxation* (Rev.), § 25.26, pp. 134-135:

> Fees, such as brokerage, legal or accounting, paid in connection with the acquisition or disposition of property, real or personal, are ordinarily capital expenditures either to be added to its cost or deducted from the selling price in determining gain or loss on its ultimate disposition. This principle is equally applicable in the case of a corporation as in the case of an individual.

The reason behind the rule as stated above is not difficult to conceive, and it is that related expenditures and receipts should be accorded equivalent tax treatment. Had the taxpayer in this case sold the capital assets of the corporation other than in the course of a corporate liquidation, there would have been no question but that the selling cost would have been subject to be offset against the selling price and the plaintiff would not be heard to con-

tend that such expenses were deductible as ordinary and necessary business expenses. Neither the rule that permits the deduction of liquidation expenses as ordinary and necessary business expenses, established in *Pacific Coast Biscuit Co. v. C.I.R.*, 32 B.T.A. 39, and the line of cases in accord, nor the provisions of §337 of the 1954 Code which provides for the non-recognition to the corporation of capital gains upon a corporate liquidation would in logic or in reason have the effect of converting capital selling expenses into ordinary business expenses. That expenses incurred in the dissolution of a corporation may be rationalized as being both ordinary and necessary business expenses, as was demonstrated in the *Pacific Coast Biscuit Co.* case, *supra*, does not furnish a rational basis for the argument that capital selling expenses are converted into ordinary and necessary business expenses if they are incurred at the time of a corporate dissolution. That § 337 likewise does not furnish a rational basis for converting what would otherwise be capital selling expenses into ordinary and necessary business expenses becomes apparent when the meaning, purpose and history of that statute is reviewed. A further look at the statute will accordingly be appropriated at this point.

The portion of § 337 relevant to the issue presented in this case reads as follows:

> (a) General rule.—If—
>
> (1) a corporation adopts a plan of complete liquidation on or after June 22, 1954, and
>
> (2) within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

It is apparent from a literal reading of the section that it refers only to non-recognition of gain or loss on sale of corporate assets in a corporate dissolution where the dissolution is accomplished in accordance with the statute. Section 337 does not, by its terms, purport to modify Section 162(a), which permits the deduction of "ordinary and necessary" business expenses. Nor does it, by its terms, purport to modify a long established rule that capital selling expenses must be offset against capital sales prices. If the statute is to have this effect, it must be arrived at by some means other than a literal reading of the statute. What then is the meaning of the statute, and what is its necessary and reasonable effect upon the law regarding capital expenses and ordinary expenses as that law existed prior to the adoption of the statute?

A review of the Congressional history of § 337 reflects that the statute was enacted to correct a tax inequity arising from certain then recent decisions of the courts. The Senate report upon the legislation reflects the following:

> Section 337 corresponds in function to section 333 of the House bill and concerns the problems raised by the decisions in *Commissioner v. Court Holding Company*, 324 U.S. 331, 65 S.Ct. 707, and *U. S. v. Cumberland Public Service Co.*, 338 U.S. 451, 70 S.Ct. 280, and the numerous related cases. These decisions involve the question of whether the corporation or the shareholder effected a sale of property in connection with the liquidation of the corporation. Under the decision in *Cumberland Public Service Co., supra*, it is indicated that in the case of a distribution of property in liquidation of a corporation followed by its sale made in fact by its shareholders, a single tax is imposed at the shareholder level. Where the shareholders in fact did not effect the sale, tax is imposed both at the corporate and at the shareholder level.

> Accordingly, under present law the tax consequences arising from sales made in the course of liquidations may depend primarily upon the formal manner in which the transactions are arranged. Your committee intends in section 337 to provide a definitive rule which will eliminate the present uncertainties. U.S. Code & Administrative News (19__) p. 4896.

It is thus apparent that the purpose of § 337 was to eliminate a possible tax inequity by eliminating the need to make a factual determination as to whether the sale of corporate assets in a corporate liquidation was made by the corporation before a distribution or by the stockholder after a distribution of corporate assets in kind. This purpose was accomplished by eliminating any tax consequence at the corporate level, leaving only single tax consequence at the stockholder level. Since the purpose of the legislation was to relieve a tax inequity, it would be to pervert that purpose for a Court to interpret the legislation as having converted capital selling expenses into ordinary and necessary business expenses where corporate assets are sold by the corporation in a dissolution rather than being distributed in kind and sold by the stockholder. For the Courts to thus create a tax inequity from legislation designed to correct a tax inequity would be not only to disregard the express terms of the statute but to read into the statute a purpose expressly contrary to that stated at the time of its enactment.

It is contended, however, that the weight of authority is to the contrary. Actually, there is no controlling authority within this Circuit upon the narrow issue here presented. The authorities in other circuits appear to be evenly divided upon the subject. Although each party cites other cases which they contend are relevant, they each rely upon two cases as being in direct support of their contentions. The Government relies upon two cases which

clearly hold that such expenses are not deductible from ordinary income. See *United States v. Morton*, 387 F.2d 441, 448-450 (C.A. 8, 1968); *Alphaco, Inc. v. Nelson*, 385 F.2d 244 (C.A. 7, 1967). On the other hand, the taxpayer relies upon two cases which clearly hold that expenses incurred in the sale of assets pursuant to a liquidation are deductible as ordinary business expenses. See *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (C.A. 4, 1965); *United States v. Mountain States Mixed Feed Co.*, 365 F.2d 244 (C.A. 10, 1966).

Taking up the cases cited by the plaintiff first, a review of the *Pridemark* case reveals that the Court did there hold, as contended by the plaintiff, that legal fees incurred in connection with a corporate liquidation sale were deductible as ordinary and necessary business expenses. However, the principal issue before the Court in that case was whether there had been a complete corporate liquidation so as to entitle the taxpayer to rely upon the provisions of § 337. The distinction between ordinary liquidation expenses, on the one hand, and expenses attributable to the liquidation sale of capital assets, on the other hand, appears not to have been raised nor discussed, the Court summarily disposing of the problem as follows:

> We reverse the Tax Court's decision that legal fees incurred in connection with the sale of assets to Golden Key are to be deducted from the gain realized on that sale. Its decision was predicated on the determination that there was no complete liquidation. Having found a liquidation, we approve *Pridemark's* deduction of these fees as ordinary and necessary business expenses incurred in liquidation. *Pacific Coast Biscuit Co.*, 32 B.T.A. 39, 42 (1935); see Note, "Certain Tax Aspects of Organization, Reorganization, and Liquidation Costs," 10 Stan. L. Rev. 112, 118-19 (1957).

It should be further noted that insofar as the Court in the *Pridemark* case relies upon the *Pacific Coast Biscuit Co.* case as authority for the proposition that legal fees incurred in a corporate liquidation sale of capital assets are deductible as ordinary and necessary business expense, its reliance is misplaced. For the *Pacific Coast Biscuit Co.* case found only that a corporate liquidation was an "ordinary and necessary" affair in the business world and that expenses incurred therein were therefore deductible as ordinary and necessary business expenses. It should be borne in mind, as a background to both the *Pridemark* and the *Pacific Coast Biscuit Co.* cases, that corporate reorganization expenses, as distinguished from corporate liquidation expenses, are uniformly held not to be deductible as ordinary and necessary business expenses. Incidentally, it was with this distinction between a corporate reorganization and a corporate dissolution that the Sixth Circuit case of *United States v. Arcade Co.*, 203 F.2d 230 (1953) dealt, the Court there holding that a dissolution was accomplished and not a corporate reorganization, with the result that legal and accounting expenses incurred in the dissolution were deductible as ordinary and necessary business expenses. The case does not go further, and, to the extent that the plaintiff relies upon it as supporting its contention that capital expenditures in a corporate dissolution are deductible as ordinary expenses, that reliance is misplaced.

Turning to the case of *United States v. Mountain States Mixed Feed Co.*, 365 F.2d 224, the Court relied upon the *Pridemark* decision in arriving at the conclusion that legal expenses incurred in the sale of assets in a corporate dissolution are deductible as ordinary and necessary business expenses. Concluding that, "It is difficult to determine any reason * * * for any distinction as to the type

or purpose of the legal work involved," the Court concluded that the sale of assets was a part of a corporate dissolution and since expenses of a corporate dissolution are generally deductible as ordinary and necessary business expenses, "The legal cost of the sale of assets should likewise be deductible." For the reasons hereinabove stated, this Court respectfully disagrees.

The taxpayer also relies upon a line of cases holding that state taxes upon a § 337 gain are deductible from ordinary income. *Commissioner v. McDonald,* 320 F.2d 109 (C.A. 5, 1963); *Hawaiian Trust Co., Ltd., Trustee v. United States,* 291 F.2d 761 (C.A. 10, 1961). These cases were at issue because of a dispute in the interpretation of § 275, which provides that no deduction shall be taken for expenses allocable to income "wholly exempt" from taxes. The Courts in the above cases held that a § 337 gain is not "wholly exempt" from taxation, since a tax may eventually be subject to payment on the gain. However, this Court has difficulty in seeing the relevance to the present issue of cases holding that § 275 is inapplicable to a § 337 gain.

As noted above, the Government relies principally upon the cases of *Alphaco, Inc. v. Nelson,* 385 F.2d 244 (C.A. 7, 1967) and *United States v. Morton,* 387 F.2d 441 (C.A. 8, 1968) as supporting its position and as being the more recent and better reasoned authority. Upon a review of the cases this Court agrees. A careful analysis of the specific problem here presented is made in both the *Alphaco* case and the *Morton* case. In each case the Court arrives at the conclusion that expenses incurred in effecting a § 337 gain are to be offset against the gain and are not deductible as ordinary and necessary expenses of carrying on businses. To the same effect see also *Towanda Textile, Inc. v. United States,* 180 F. Supp. 373 (Ct. of Cl.,

1960). In arriving at this conclusion the Court in the *Alphaco* case stated:

> We perceive nothing in the language or in the ultimate objective of section 337 indicative of any purpose to carve out an exception to that general rule so as to transmute the selling costs, for tax purposes, from their normal character as capital selling expenses into ordinary business expenses. On the contrary, to permit the costs of selling the corporate assets to be deducted by the corporation as ordinary business expenses would frustrate the purpose for which section 337 was enacted. (385 F.2d 244 at 245)

In an even more fully reasoned opinion, the Court in the *Morton* case stated:

> To allow what ordinarily is considered as a capital expenditure in the sale of a capital asset or the collection of insurance proceeds producing a capital gain as an ordinary business expense is thwarting and overextending the congressional purpose in enacting § 337. This remedial legislation had for its purpose the removal of the specter of double taxation assessed on technicalities in corporate liquidations. This purpose was achieved by eliminating any corporate tax on any gain or loss resulting from the sale or exchange of corporate assets in a qualifying plan of complete corporate liquidation and shifting the tax consequences to the distributee stockholders; thus treating the whole transaction of liquidation as though a distribution in kind had been made to the stockholders and the sale or exchange of the assets then made by the stockholders. Under the procedure of the stockholders selling the corporate assets after distribution in kind the usual legal and selling expenses in connection with a sale would be considered as capital expenses chargeable against the sale proceeds. We do not think Congress intended any preference to distributee shareholders of liquidating corporations other than the elimination of double taxation; nor do we

think Congress intended to change the prevailing accounting principle of treating capital expenditures as chargeable only against capital gains or losses. See *Winer v. Commissioner of Internal Revenue*, 371 F.2d 684 (1 Cir. 1967).

This Court accordingly concludes that legal fees and other expenses incurred in the sale of corporate assets in a corporate liquidation made pursuant to the provisions of § 337, Title 26 U.S.C.A., must be offset against the capital gain realized in the sale and may not be deducted as ordinary and necessary business expenses.

An order will accordingly enter dismissing the plaintiff's action.

FRANK W. WILSON,
United States District Judge.

MEMORANDUM OF DISTRICT COURT ON MOTION TO ALTER OR AMEND JUDGMENT OF DISMISSAL.

(Filed September 23, 1968.)

This case is before the Court upon the plaintiff's motion to alter or amend the judgment of dismissal heretofore entered in accordance with the opinion of the Court and in lieu thereof to enter a judgment for the plaintiff in the amount sued for. The plaintiff's original contention in this lawsuit was that it was entitled to an income tax refund for the year 1963 to be calculated on the basis of the plaintiff being entitled to deduct as ordinary business expense the sum of $156,961.79, being legal and professional fees incurred during the year in the sale of corporate assets upon a corporate dissolution. The Court having concluded in its opinion that the expenses, being expenses incurred in the sale of capital assets, must be offset against

the capital gains, held that such expenses were not ordinary and necessary business expenses deductible in full in the year in which they were incurred.

The plaintiff now seeks to alter the theory of its case and contend that since a portion of the gain realized upon the sale of its assets upon dissolution constituted a gain attributable to depreciable property, such portion of the gain being in the sum of $267,294.46, and since that portion of the gain was included as ordinary income under § 1245 of the 1954 Code, then the total sales expense of $156,961.79 should be offset against that portion of the gain taxable as ordinary income, thereby accomplishing the tax consequence originally sought by the plaintiff.

The Court is of the opinion that while the plaintiff's motion is without merit insofar as it seeks to deduct the full amount of the sales expense from the portion of the gain taxable as ordinary income, the motion is not wholly without merit. As stated in the opinion of the Court, the reason for requiring that expenses incurred in the sale of capital assets be offset against the selling price in determining gain or loss is that related expenditures and income should be accorded equivalent tax treatment. In the present case a total sales expense of $156,961.79 was incurred in the sale of corporate assets. From this sale a capital gain of $5,941,340 was realized. Also realized from the sale was a gain of $267,294.46, which pursuant to § 1245 of the 1954 Code was taxable as ordinary income as being a recovery of depreciation previously taken on the property sold. It is apparent that the sales expenses incurred were incurred in a sale which resulted in both a capital gain and a gain taxable as ordinary income. It is also apparent that the portion of the selling expenses attributable to the production of capital gain should be offset against the capital gain thus produced and the

portion of the selling expenses attributable to the production of gain taxable as ordinary income should be offset against the gain taxable as ordinary income thus produced. The total expenses would be subject to apportionment in the proportion that the capital gain and the gain taxable as ordinary income each respectively bear to the total gain. Under the facts of this case the ratio of the capital gain to the total gain ($5,941,340÷$6,208,634.46) would be 95.69%. The ration of the ordinary gain to the total gain ($267,294.46÷$6,208,634.46) would be 4.31%. The plaintiff accordingly would be required to offset $150,096.73 (95.69% of $156,961.79) of the total selling expense against capital gains and would be entitled to deduct $6,865.06 (4.31% of $156,961.79) of the total selling expenses as ordinary business income incurred to acquire gain taxable as ordinary income. The previous order of the Court dismissing this action will be set aside and a judgment will enter for the plaintiff in the amount of the tax refund due when calculated in accordance with this opinion. The parties will submit a judgment accordingly.

FRANK W. WILSON,
United States District Judge.

MEMORANDUM OF DISTRICT COURT ON PLAINTIFF'S MOTION TO REVISE MEMORANDUM OF SEPT. 23, 1968.

(Filed October 15, 1968.)

This case is before the Court upon the plaintiff's motion seeking to have the Court to revise its memorandum opinion filed herein upon September 23, 1968. The Court is of the opinion that all matters raised by the plaintiff in its motion have been appropriately dealt with in

prior opinions of the Court herein with the exception of a mathematical error called to the Court's attention. It appears from the stipulations of the parties that the total gain realized from the sale of capital assets, both recognized gain and non-recognized gain, was $5,941,340.00, whereas the Court used the figure of $6,208,634.46 as being the total gain in making its calculations, the Court having overlooked the fact that the taxable gain of $267,249.46 was included within the $5,941,340.00 figure and was not in addition thereto. These matters were correctly found by the Court in its original opinion. The calculation as contained in the latter portion of the Court's memorandum of September 23, 1968, will accordingly be amended to read as follows:

> "Under the facts of this case the ratio of non-recognized capital gain to total gain ($5,674,045.54÷$5,941,340.00) would be 95.50%. The ratio of recognized gain to total gain ($267,294.46÷$5,941,340.00) would be 4.50%. The plaintiff would accordingly be required to offset $149,898.51 (95.50% of $156,961.79) of the total selling expense against non-recognized capital gains and would be entitled to deduct $7,063.28 (4.50% of $156,961.79) of the total selling expenses as ordinary business income incurred to acquire gain taxable as ordinary income."

The parties will submit a judgment accordingly.

FRANK W. WILSON,
United States District Judge.

OPINION OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(Decided February 5, 1970.)

Before PHILLIPS, Chief Judge, and CELEBREZZE and McCREE, Circuit Judges.

PER CURIAM. The taxpayer sued for the recovery of federal income taxes for the year 1963 in the amount of $81,620.13 plus interest. The District Court initially entered a judgment in favor of the Government, but subsequently modified the judgment and granted a refund to the taxpayer in the sum of $4,212.72 plus interest. The taxpayer appeals from that part of the judgment adverse to its claim. That part of the judgment of the District Court granting the partial refund is not an issue on this appeal. A copy of the original opinion of the District Court is made an appendix hereto, not including the supplemental order dealing with the partial refund.

The issue on appeal is whether the District Court was correct in holding that selling expenses incurred by the taxpayer corporation in connection with the liquidation sale of its capital assets pursuant to § 337 of the Internal Revenue Code of 1954 must be offset against the selling price, resulting in reduction of the capital gain from the sale, and were not ordinary business expenses deductible from the ordinary income of the taxpayer reported in its final return.

This Court agrees with the conclusion of the District Court for the reasons set forth in the opinion of District Judge Frank W. Wilson, Appendix hereto.

Affirmed.

APPENDIX.

NOTE: The Opinion of the District Court appears at page 12, *supra*, and is not here repeated.

JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(Entered February 5, 1970.)

APPEAL from the United States District Court for the Eastern District of Tennessee.

THIS CAUSE came on to be heard on the record from the United States District Court for the Eastern District of Tennessee and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby affirmed.

It is further ordered that Defendant-Appellee recover from Plaintiff-Appellant the costs on appeal, as itemized below, and that execution therefor issue out of said District Court.

Entered by order of the Court.

CARL W. REUSS,
Clerk.

In the Supreme Court of the United States

OCTOBER TERM, 1969

No. 1346

LANRAO, INC., PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

On December 2, 1963, petitioner adopted a plan of complete liquidation. Within the twelve-month period beginning on that day, petitioner sold all of its assets and distributed the proceeds (less assets retained to meet claims) to its stockholders in complete liquidation. The sale and liquidation were made in conformity with Section 337(a) of the Internal Revenue Code, which provides that no gain or loss shall be recognized upon the sale of property incident to a Section 337 liquidation. (Pet. App. 12-13.)

cific problem here does not seem necessary now. Accordingly, the United States opposes the petition.

Respectfully submitted.

ERWIN N. GRISWOLD,
Solicitor General.

MAY 1970.

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